

Strategic incentives for market share [☆]

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Received 5 October 2006; received in revised form 30 March 2007; accepted 11 April 2007

Available online 20 April 2007

Abstract

Market share objectives are prominent in many industries, especially where managers pay much attention to league table rankings. This paper explores the strategic rationale for giving managers incentives based on market share, motivated by evidence from executive compensation practice in the automotive and investment banking industries. Strategic incentives for market share dominate the well-known sales revenue contracts analyzed in much of the literature, but perhaps surprisingly also lead to *less* competitive outcomes. The more general lesson is that, when competing in strategic substitutes, players will wish to commit to aggressive conduct, but also make their behaviour less manipulable by rivals.

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JEL classification: D21; D43; G24; L62; M52

Keywords: Strategic delegation; Market share; Executive compensation; League tables

1. Introduction

Market share objectives are prominent in many industries. Countless press reports, mission statements and interviews with corporate executives reveal that managers place significant emphasis on their firm's market share. At the same time market share objectives are a sign of aggressive competition. This is particularly apparent in the automotive industry where buyer

discount programs have for years been squeezing the profitability of major producers, perhaps most notably General Motors. Indeed, *The Economist* concludes a recent survey on the industry by noting that “car firms must reinvent themselves to seek profit, not just market share”.¹

This paper shows that strategic considerations provide a rationale for giving managers incentives based on market share. It also discusses empirical evidence on executive compensation practice in the automotive and the investment banking industries. In both of these, as predicted by the theory, firms use *explicit* contractual incentives related to market share. Therefore, the attention paid by managers in these industries to so-called league table rankings—which are based on market share, not profits—can be understood as a natural corollary of the incentive structure.

[☆] I would like to thank Ian Jewitt for guidance and encouragement. I am grateful to the Editor Neil Gandal, two anonymous referees, Eric Budish, Pablo Casas-Arce, Daniel Cerquera, Simon Cowan, Kohei Kawamura, Paul Klemperer, John Quah and Max Tse for helpful comments and especially to Meg Meyer for many discussions on this topic. Thanks also to seminar participants at Oxford, SMYE 2005 (Geneva) and IIOC 2006 (Boston). Financial support from the ESRC is gratefully acknowledged.

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¹ See *The Economist*, September 4, 2004.

The strategic value of commitment to non-profit maximizing objectives was first recognized by Schelling (1960). This idea was introduced into the industrial organization literature in seminal papers by Vickers (1985), Fershtman and Judd (1987) and Sklivas (1987). These papers find that, when competing in strategic substitutes, owners wish to delegate decision-making to managers who are given aggressive sales incentives. Firms end up in a prisoners' dilemma as a result.² This has implications for a wide range of issues in industrial organization, including collusion (e.g., Lambertini and Trombetta, 2002), patent licensing (e.g., Saracho, 2002) and mergers (e.g., Ziss, 2001).

Motivated by the empirical evidence, the present analysis aims to clarify the implications of strategic incentives for market share. These are shown to dominate the well-known sales revenue (and output-based) contracts analyzed in much of the literature—as well as simple profit maximization. Moreover, and perhaps surprisingly, the incentive equilibrium with market share contracts turns out to be *less* competitive than under the other contracts—despite the inherent relative performance component. Players remain in a prisoners' dilemma, but in a less severe one.

The more general lesson from the model is that managerial incentive contracts have *two* roles in strategic settings. The first is very well-known: Contracts constitute a commitment to making managerial behaviour *more aggressive*. The second is largely neglected in the literature: Contracts can make managerial behaviour *less susceptible to strategic manipulation by rivals*. Contracts observed in practice are rich enough to assume both of these roles.

The remainder of the paper is organized as follows. Section 2 discusses empirical evidence for executive compensation based on market share. Section 3 describes the benchmark Cournot model that is used to explore the strategic advantages associated with market share incentives. Section 4 presents the results from the model and provides further discussion and extensions. Section 5 concludes.

The Appendix contains detailed derivations for proofs omitted from the main text for expositional continuity.

2. Evidence from executive compensation

This section discusses empirical evidence on executive compensation practice in the automotive and

investment banking industries. The focus throughout lies on analyzing US corporate proxy statements.³ For present purposes, the relevant component of the proxy statement is the “Report of the Compensation Committee”. Firms in both industries use *explicit* contractual incentives related to market share.

2.1. Automotive industry

The car industry is dominated to a large extent by the “Big Four” producers, namely General Motors, DaimlerChrysler, Ford and Toyota, who together accounted for over \$600 billion in 2003 annual sales. The survey by The Economist mentioned in the introduction also notes that most manufacturers are operating at high output levels and there has correspondingly been considerable pressure on prices and margins. This is especially evident given the aggressive discounts, interest-free loans *etc.* given to consumers on their car purchases, most notably in the US. All major producers make use of these buyer discount programs to help boost market share, including the Japanese firms such as Toyota and Nissan.⁴

The following quote from a compensation committee report shows that executive compensation at General Motors is indeed directly based on market share:

“As in previous years, management recommended that the Committee establish very aggressive performance targets for 2003. We (the Compensation Committee) tied the payment of annual incentive awards to meeting specific levels of net income, ... market share...” (General Motors Corp., 2004 Proxy statement).

Furthermore, the quote reveals that management and the compensation committee both recognize the aggressive nature of a market share component. As basic economic analysis would suggest, managers' objectives and public statements are compatible with the contractual incentives provided. Indeed, General Motors' “2004 Priorities/Targets” include the management objective of “increasing automotive market share in all

² See Gal-Or (1997) for a survey of the earlier contributions to this literature.

³ Proxy statements are mandatory disclosures by publicly listed US firms that contain management reports on the firm's strategy and financial results as well as committee reports on executive compensation, corporate governance, audit *etc.* These statements are sent to shareholders whenever corporate matters are subject to a shareholder vote. Typically, proxy statements are issued at least once a year and are freely available in the public domain.

⁴ The magnitude of such buyer incentives can be rather large. For example, in June 2005, General Motors offered the largest discounts averaging \$7032 per vehicle while Toyota offered an average of \$4022. (See *Financial Times*, August 2, 2005.) Operating profit margins in the first half of 2005 were “low or non-existent” for several firms in the industry. (See *New York Times*, August 30, 2005.)

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